



Putting the U.S. Budget Challenge in International Context

Donald Marron | November 18, 2009

The United States faces daunting fiscal challenges. The financial crisis, the ensuing economic crisis, and our policy response have lifted the federal budget deficit to previously unthinkable levels: \$1.4 trillion in fiscal 2009, equivalent to 10% of gross domestic product. And there's more to come. The Obama administration's most recent projections show a total of \$9 trillion in federal deficits over the coming decade, with the federal debt rising faster than the economy in every year. Even after the economy recovers, large deficits will persist as rising entitlement spending outstrips federal revenues.

In short, the United States is on an unsustainable fiscal path.

A recent report by the International Monetary Fund helps put the U.S. fiscal challenge into perspective. In "The State of Public Finances Cross-Country Fiscal Monitor: November 2009", the IMF evaluated the fiscal situation of 22 advanced economies, estimating three figures for each:

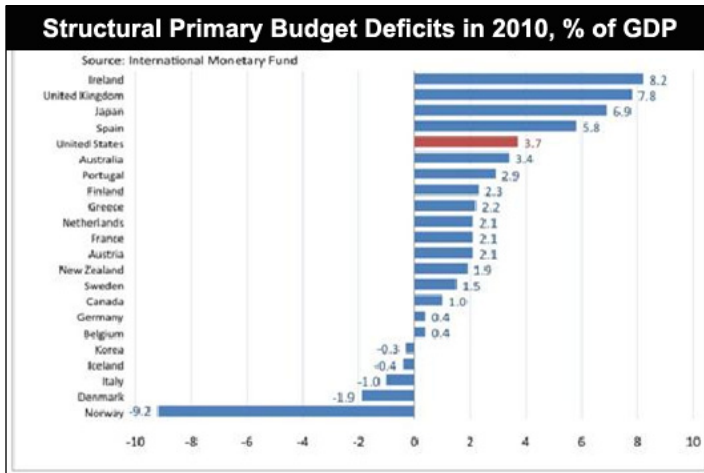
- The primary budget deficit that each economy will incur in 2010. The primary deficit is simply the difference between revenues and spending, excluding interest on government debt. That's a useful measure because it focuses on the spending and revenue choices that governments are making.
- The cyclically-adjusted or structural primary deficit that each economy will incur in 2010. This estimate strips out the effects of the business cycle in order to focus on the underlying (i.e., structural) posture of the government budget.
- The primary budget adjustment each country would have to make in order to return its debt-to-GDP ratio to an appropriate level. For most economies,

including the United States, that level was assumed to be 60%, which is about where the United States was before the financial crisis. (The target was different for a few countries that have lower debts.)

To make things comparable across nations, the IMF combines all levels of government together, so its figures for the United States include not only the federal government, but also state and local governments. Moreover, the IMF focuses on the gross federal debt, which includes the debt owed to the Social Security Trust Fund, rather than just the publicly-held debt. For both these reasons, the deficit and debt measures are larger than the figures many analysts use for the federal government alone.

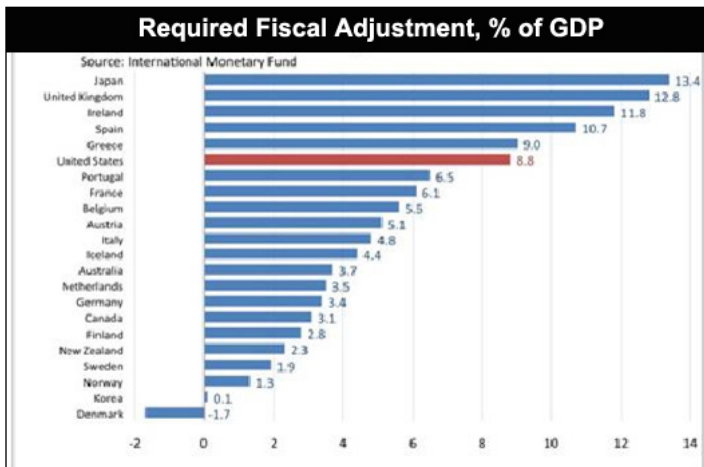
The IMF estimated that the United States will run a primary government deficit of 8.1% of GDP in 2010. The weak economy and the response to the financial crisis account for slightly more than half of this deficit. The remaining portion—equal to 3.7% of GDP—is structural and thus likely to persist in coming years. That structural primary deficit is large and troubling. In general, an economy has to run a small primary surplus in order to prevent the government debt from growing faster than the economy. Thus, to merely stabilize the overall government debt relative to the economy, the United States would have to undertake a fiscal adjustment—a combination of spending cuts and tax increases—of more than 4% of GDP.

That fundamental imbalance is the fifth highest among advanced economies:



Four countries have larger structural imbalances than the United States. Ireland, the United Kingdom, and Spain had even more severe credit booms and busts, while Japan has run large deficits for many years. (At the other extreme, Norway runs large structural surpluses because of its oil production.)

Eliminating primary deficits is key to restoring a nation's fiscal strength. In many cases, however, it is only a first step. Many nations may also need to take a second step: reducing the size of the debt relative to the economy. The IMF thus estimated how large spending cuts and revenue increases would have to be between 2010 and 2020 in order to return nations to a more manageable level of government debt by 2030:



According to these estimates, the United States would need to cut spending and increase tax revenues by a combined 8.8% of GDP between 2010 and 2020, almost 0.9 percentage point per year, in order to get the debt-to-GDP ratio down to 60% by 2030. That's an enormous adjustment, topped only by those that would be required in Japan, the United Kingdom, Ireland, Spain, and Greece.

To put that adjustment in context, note that the U.S. economy currently totals a bit more than \$14 trillion. To reduce borrowing by 0.9% of GDP, one-year's target in the IMF scenario, the government would thus have to cut spending or increase taxes by about \$120 billion per year on a permanent basis. That's equivalent to half of federal spending on Medicaid in 2009. And then the government would have to enact similar, permanent spending cuts and tax increases in each of the nine following years.

These estimates are, of course, based on numerous assumptions and are subject to considerable uncertainty. In particular, they assume a very aggressive goal for reducing the debt in coming years. So the specific numbers should be taken with a large grain of salt. However, several qualitative findings appear robust:

- The United States faces enormous fiscal challenges. Stabilizing the debt-to-GDP ratio will require substantial changes in government spending and revenues. Getting that ratio down to more reasonable levels will require even larger changes.
- The United States is not alone in facing these challenges. The majority of advanced economies also face substantial adjustments, and several face even larger challenges than the United States.
- As the world economy recovers, many advanced economies will feel pressure to address their fiscal imbalances.